

## Franchise Tax Board

## ANALYSIS OF AMENDED BILL

Author: Lempert Analyst: Marion Mann DeJong Bill Number: AB 1614  
Related Bills: AJR 20, SB 1908 Telephone: (916) 845-6979 Amended Date: 05/27/98  
Attorney: Doug Bramhall Sponsor: \_\_\_\_\_

**SUBJECT:** California Internet Tax Freedom Act

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended \_\_\_\_\_.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended \_\_\_\_\_.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO \_\_\_\_\_.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED \_\_\_\_\_ STILL APPLIES.

☒ OTHER - See comments below.

SUMMARY OF BILL

This bill would enact the "California Internet Tax Freedom Act," prohibiting, with specified exceptions, the state and any local government (including political subdivisions) from imposing, assessing or attempting to collect any new taxes imposed on Internet access and Online Computer Services, and prohibiting discriminatory application of existing or new taxes, as defined, to Internet access or Online Computer Services.

For purposes of the Sales and Use Tax Law, this bill also would provide that:

- A retailer is not "engaged in business in this state" based solely on the performance of specified services by a representative or independent contractor.
- The use of a computer server on the Internet would not be considered a factor in determining whether the retailer has a substantial nexus within California.
- Certain entities (i.e., Internet service provider, on-line service provider, internetwork communication service provider, other Internet access service provider, or World Wide Web hosting services) would not be deemed the agent or representative of any out-of-state retailer.

Since the changes to the Sales and Use Tax Law do not impact the programs administered by this department, this analysis will discuss only the California Internet Tax Freedom Act.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
<input type="checkbox"/> SA	<input type="checkbox"/> O	<input type="checkbox"/> NAR
<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Will Bush

6/17/98

#### SUMMARY OF AMENDMENT

The May 27, 1998, amendments made changes to the Sales and Use Tax Law and substantially modified the California Internet Tax Freedom Act.

#### EFFECTIVE DATE

As an urgency statute, this bill would become effective immediately upon enactment. This bill specifies that the California Internet Tax Freedom Act would become inoperative ten years from the effective date of this bill.

#### BACKGROUND

Currently, no federal or state law exists specifically addressing the taxation of business activities conducted over the Internet.

However, **federal legislation (H.R. 3849)** has been introduced that would impose a three year "moratorium" on state and local taxes on electronic commerce. This moratorium would not apply to any taxes on Internet access or online services generally imposed and actually enforced under state law before March 1, 1998.

H.R. 3849 would also establish a Commission on Electronic Commerce to make recommendations to Congress within two years regarding whether the Internet should be taxed and, if so, how taxes can be applied without subjecting Internet and electronic commerce to special, discriminatory, or multiple taxation.

#### SPECIFIC FINDINGS

**Federal Public Law 86-272** prohibits a state from imposing an income tax (direct or indirect) upon a taxpayer whose only activity carried on within the state is "solicitation" of orders for the sale of tangible personal property, where the orders are sent outside the state for approval and, if approved, are filled and delivered from a stock of goods located outside the state.

**Current Bank and Corporation Tax Law (B&CTL)** imposes a franchise tax on all corporations incorporated in California, qualified by the office of the Secretary of State to do business in California or doing business in California. The franchise tax is measured by the corporation's income of the preceding year and is paid for the privilege of doing business in the following year. All corporations subject to the franchise tax must pay a minimum tax of \$800 per year. An income tax is imposed on corporations deriving income from sources in California but not doing business in California. Taxpayers subject to the income tax are not required to pay the minimum tax.

The B&CTL provides for the use of an apportionment formula when assigning business income of multistate and multinational corporations to California for tax purposes. For most corporations, this formula is the average of the factors of property, payroll and double-weighted sales applied against worldwide income. Each factor is the ratio of in-state activity to worldwide activity. For purposes of the sales factor, sales are generally "sourced" to the destination state.

**Current Personal Income Tax Law (PITL)** imposes an income tax on individuals, fiduciaries, estates and trusts. Residents of California are taxed on their entire taxable income, regardless of where it is derived. Nonresidents are taxed only on income derived from California sources.

The PITL requires every partnership doing business in California or in receipt of income from California sources, regardless of the amount, to file a tax return. Generally, the income of a partnership is computed in the same way as that of an individual. However, a partnership does not pay tax on the partnership's income; instead the individual partners report their distributive shares of the partnership's income or loss on their personal income tax returns.

Generally, in a case in which the partner is a corporation, B&CTL apportionment rules apply. If the business activity of the partnership and the corporate partner is unitary, the partner adds its distributive share of partnership business income to its own income and apportions the resulting net income using an apportionment formula consisting of the aggregate of its own property, payroll and sales and its share of the partnership's payroll, property, and sales, in accordance with the partner's interest in the partnership. The resulting combined income represents the partner's total California business income from a single unitary business enterprise. If a partner is not unitary with its partnership, the partner's distributive share is treated as a separate trade or business of the corporate partner and apportioned to California according to the partnership factors.

**Current PITL** also imposes specific taxes on other business entities. Limited liability companies (LLC) not treated as corporations for California tax purposes are required to pay an annual LLC tax of \$800 and an annual fee based on total income reportable to California. Limited partnerships and limited liability partnerships also are liable for an \$800 tax.

**This bill** would enact the "California Internet Tax Freedom Act." This Act would prohibit the state and any local government (including political subdivisions) from imposing, assessing or attempting to collect any of the following:

- A tax on Internet access, Online computer services, or the use of Internet access or any Online Computer Services.
- A bit tax or bandwidth tax.
- Any discriminatory tax on Online Computer Services or Internet access.

This prohibition against the imposition of taxes or fees would not apply to any existing tax (including any sales or use tax, utility user tax, or franchise fee) that is imposed or assessed in a uniform and nondiscriminatory manner without regard to whether the activities or transactions taxed are conducted through the use of the Internet, Internet access, or Online Computer Services.

The prohibition also would not apply to any franchise fee on interactive computer services delivered over a cable television system, unless the Federal Communications Commission or a court finds that those services are not cable services.

**The bill** would provide the following definitions.

- "Internet" would mean the global information system that is logically linked together by a globally unique address space based on the Internet Protocol (IP), or its subsequent extension; and is able to support communications using the Transmission Control Protocol/Internet Protocol (TCP/IP) suite, or

its subsequent extensions, or other IP-compatible protocols; and provides, uses or makes accessible, either publicly or privately, high level services layered on the communications and related infrastructure described in the bill.

- "Online Computer Services" would mean the offering or provision of information, information processing, and products or services to a user via the Internet, regardless of whether they are offered as part of a package of services that are combined with Internet access and offered to the user for a single price, or provided and billed separately. "Online computer services" would not include telephone services taxed under Section 4251 of Title 26 of the United States Code.
- "Internet access" would mean the offering or provision of the storage, computer processing, and transmission of information that enables the user to make use of the resources found via the Internet. "Internet access" would not include telephone service to the extent that the amounts paid for those services are taxed under Section 4251 of Title 26 of the United States Code.
- "Tax" would have the same meaning as "tax" in Section 3 of Article XIII A of the California Constitution, whether imposed by the state, city, county, city and county, or special district.
- "Franchise fee" would mean the fee imposed pursuant to Sections 6001 and 6231 of the Public Utilities Code, or Section 53066 of the Government Code.
- "Discriminatory" would mean a tax levied on Online Computer Services or Internet access that is (1) at a rate higher than that imposed on other businesses or services generally, or (2) applicable to the taxpayer solely by virtue of the offering of or the use of Online Computer Services or Internet access.
- "Bit tax" would mean any transactional tax imposed on or measured by the amount of digital information transmitted electronically, or any transactional tax imposed on or measured according to any of the technological or operating characteristics of the Internet.
- "Bandwidth tax" would mean any transactional tax imposed on or measured by the physical capacity of an available signal to transmit digital information electronically.

**The bill** would specify that it is not intended to interfere with existing sources of revenue that provide funding for local government services. It is intended to impose a moratorium on new taxes imposed on Internet access and Online Computer Services and the discriminatory application of existing or new taxes to Internet access or Online Computer Services.

#### Policy Considerations

In the declarations of the bill, the Legislature recognizes that electronic commerce could be subject to multiple levels of taxation and that a uniform national policy regarding taxation of the Internet is needed. However, this bill would provide a ten-year moratorium, far beyond the three-year moratorium proposed by Congress.

Implementation Considerations

Implementation of this provision of the bill would occur during the department's normal annual system update.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

This bill would not significantly impact Personal Income Tax or Bank and Corporation Tax revenues.

BOARD POSITION

Pending.

The Franchise Tax Board voted at its July 21, 1997, meeting to support this bill as amended July 3, 1997.